IT 01-0083-GIL 10/19/2001 BASE INCOME

General Information Letter: Items of income or deduction included in taxable income as the result of an IRC Section 338 election are included in base income in the same manner and amounts as included in the taxable income of the taxpayer.

October 19, 2001

Dear:

This is in response to your letter dated October 15, 2001, in which you request a letter ruling. The nature of your request and the information you have provided require that we respond with a General Information Letter, which is designed to provide general information, is not a statement of Department policy and is not binding on the Department. *See* 86 Ill. Adm. Code 1200.120(b) and (c), which may be found on the Department's web site at www.revenue.state.il.us.

In your letter you have stated the following:

Thank you for speaking with me last Friday, October 21, 2001 regarding Illinois' tax treatment of IRC Section 338 elections. As I mentioned, enclosed is a tentative draft of your responses to my questions for your review. Please take a moment to look it over, and let me know if there are any changes or corrections that need to be made.

Questions

1. Does your state recognize elections by C corporations to be taxed as S corporations/or S corporations to be taxed as C corporations for state income tax purposes? Or does your state automatically follow whatever entity election was made at the federal level?

   Answer: No.

2. Does your state recognize IRC Section 338(g) and/or 338(h)(10) elections by C corporations and/or S corporations for state income tax purposes?

   Answer: Yes. However, an S corporation that makes a 338(h)(10) election will be subject to the Personal Property Tax Replacement Income Tax to the extent that the election results in separately-stated and non-separately stated income under Section 1363. Moreover, an S corporation shareholder whose corporation makes a 338(h)(10) election will be subject to Illinois tax to the extent that the election results in an item of income included in federal adjusted gross income.

3. Can either an S or C corporation that has elected Section 338 treatment for federal income tax purposes elect out of a Section 338 treatment for state income tax purposes? Or are they bound by their federal election?

   Answer: A federal 338 election is binding on the entities. There is no opt-out provision for state purposes.

4. If an S or C corporation has a Section 338 election for state income tax purposes, and that S or C corporation is the Target Corporation, does it have the responsibility for filing its final return for state tax return? If not, does the Acquiring corporation? What type of return is filed for these purposes?

   Answer: Illinois follows the federal provisions for final return filing. Therefore, whichever entity has the responsibility for filing a final federal return also has the responsibility for filing the final state tax return.

5. If the S or C corporation (as Target/Selling Corporation) is a part of a federal consolidated group, and it has a Section 338 election in place, can it file a separate return for state income tax purposes?

   Answer: A target corporation that file a separate Illinois state return must take into account gain or loss arising from the 338 election as if it had filed a separate federal return.

6. Following up on question 5, if the S or C corporation files a separate return for state income tax purposes, how would the state treat the gain/loss arising from a section 338 election? (assume that at the federal level, the consolidated group allocated the gain/loss arising from the 338 transaction). Does the S or C corporation have to recompute its federal tax base and recognize the entire gain/loss arising from the 338 election?

   Answer: Yes.

7. If an S or C corporation that has a section 338 election mergers out of existence or terminates, and deductible expenses related to the 338 election are incurred after the S or C corporation has merged/liquidated out of existence and filed final returns, WHO bears the tax burden for post-termination expenses? Does the S shareholder or C shareholder have to bear the deductible post-termination expenses? Or can the terminated S or C corporation "file" amended returns?

   Answer: Illinois will follow the federal position on this issue.

Response

Section 1501(a)(28) of the Illinois Income Tax Act (the "IITA"; 35 ILCS 5/101 *et seq.*) provides that:

> The term "Subchapter S corporation" means a corporation for which there is in effect an election under Section 1362 of the Internal Revenue Code, or for which there is a federal election to opt out of the provisions of the Subchapter S Revision Act of 1982 and have applied instead the prior federal Subchapter S rules as in effect on July 1, 1982.

Thus, any corporation that has elected to be treated as a Subchapter S corporation for federal income tax purposes must be treated as a Subchapter S corporation for Illinois income tax purposes. Furthermore, there is no provision for a corporation that has not made a Subchapter S election for federal income tax purposes to elect Subchapter S corporation treatment for Illinois income tax purposes.

Section 203(b)(1) of the IITA provides:

> In the case of a corporation, base income means an amount equal to the taxpayer's taxable income for the taxable year as modified by paragraph (2).

This provision applies to all corporations, including Subchapter S corporations. Section 203(e)(2)(G) provides that, in the case of a Subchapter S corporation:

> the taxable income of such corporation determined in accordance with Section 1363(b) of the Internal Revenue Code, except that taxable income shall take into account those items which are required by Section 1363(b)(1) of the Internal Revenue Code to be separately stated.

Section 203(h) of the IITA provides:

> Except as expressly provided by this Section there shall be no modifications or limitations on the amounts of income, gain, loss or deduction taken into account in determining gross income, adjusted gross income or taxable income for federal income tax purposes for the taxable year, or in the amount of such items entering into the computation of base income and net income under this Act for such taxable year.

There is no provision in Section 203 of the IITA that would require or allow modification of a corporation's federal taxable income resulting from an election under Section 338 of the Internal Revenue Code (the "IRC"). Accordingly, any item of income or loss included in the federal taxable income of a corporation as the result of an IRC Section 338 election is automatically included in its base income as well, and any item of income or loss excluded from the computation of a corporation's federal taxable income as the result of an IRC Section 338 election is automatically excluded from its base income as well. This principle applies to contingencies resolved after the transaction: any item of income, loss or deduction included in the federal taxable income of a corporation as the result of the resolution of a contingency after an IRC Section 338 transaction is included in the base income of that corporation as well.

Section 502(a) of the IITA provides:

> A return with respect to the taxes imposed by this Act shall be made by every person for any taxable year:
>
> (1) For which such person is liable for a tax imposed by this Act, or

(2) In the case of a resident or in the case of a corporation which is qualified to do business in this State, for which such person is required to make a federal income tax return, regardless of whether such person is liable for a tax imposed by this Act.

Thus, any corporation that has Illinois net income as the result of an IRC Section 338 transaction or that is qualified to do business in Illinois and required to file a federal income tax return as the result of an IRC Section 338 transaction must file an Illinois income tax return as well.

With respect to corporations filing federal consolidated returns, the IITA does not follow federal consolidated return rules. Rather, a corporation (including a Subchapter S corporation) that is a member of a unitary business group, as defined in IITA Section 1501(a)(27), must apportion its business income to Illinois on a combined basis with the other members of the group. Corporations (other than Subchapter S corporations) who are members of a unitary business group are required to file a single, combined return. See IITA Section 502(e). All other corporations must file separately and, if they are members of a federal consolidated group, compute their federal taxable incomes as if they are not and have never been members of a federal consolidated group. See IITA Section 203(e)(2)(E).

As stated above, this is a general information letter which does not constitute a statement of policy that applies, interprets or prescribes the tax laws, and it is not binding on the Department. If you are not under audit and you wish to obtain a binding Private Letter Ruling regarding your factual situation, please submit all of the information set out in items 1 through 8 of Section 1200.110(b). If you have any further questions, you may contact me at (217) 782-7055.

Sincerely,

Paul S. Caselton
Deputy General Counsel -- Income Tax